IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1249

THE JOHNS HOPKINS UNIVERSITY,
Cross-Petitioner,

v.

WILLIAM E. HUTTON; JOSEPH A. W. IGLEHART; JAMES J. LEE; WILLIAM C. MILLER; EARL K. BASSETT; JOHN M. BLEAKIE; ERNEST E. KEUSCH; BENJAMIN D. WILLIAMS; JOHN J. ANGLIM; REGINALD N. BARNARD; JUSTIN J. STEVENSON, JR.; J. LOGAN BURKE; JAMES M. HUTTON, III; THOMAS C. CAFONE; HART HAGIN; CLINTON J. COOMBS; ARTHUR T. HAMILL; JAMES M. HUTTON, III, EXECUTOR OF THE ESTATE OF DEFENDANT JAMES M. HUTTON, JR., DECEASED; ROBYN B. HALL, VERNON H. HALL, III and DUDLEY HALL, EXECUTORS OF THE ESTATE OF DEFENDANT VERNON H. HALL, II, DECEASED; and W. E. HUTTON & CO., A PARTNERSHIP,
Cross-Respondents.

CROSS-PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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Table of Contents

	PAGE
Opinions Below	2
Jurisdiction	3
Questions Presented	3
Statutory Provisions Involved	5
Statement of the Case	7
Reasons for Granting the Writ	12
1. The Court of Appeals' Decision Regarding Waiver of the Right of Rescission for Fraud Directly Conflicts with the Applicable and Controlling Decisions of the Court, particularly *Pence v. Langdon*, 99 U.S. 578 (1878)	12
2. The Court of Appeals' Decision Regarding Waiver of the Right of Rescission for Fraud Violative of Section 10(b) of the Securities Exchange Act Directly Conflicts with Decisions of Other Courts of Appeals, particularly *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962); 333 F.2d 568 (9th Cir. 1964)	15
3. The Court of Appeals has Decided Federal Questions Concerning the Availability and Waiver of the Remedy of Rescission for Fraud Violative of Section 10(b) of the Securities Exchange Act, in Conflict with Basic Principles of Law and the Remedial Purposes of the Statute Expressly Recognized by this Court, which Questions are of Great and Recurring Importance in its Application	17
Conclusion	25

Table of Citations

Cases

Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972)	19

PAGE

Azalea Meats, Inc. v. Muscat, 386 F.2d 5 (5th Cir. 1967) 20
Badger v. Badger, 69 U.S. 87 (1864) 23
Bailey v. Glover, 88 U.S. 342 (1874) 20
Barker v. Wingo, 407 U.S. 514 (1972) 23
Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969) 20, 23
Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 303 F.2d 527 (10th Cir. 1962) 24
Fay v. Noia, 372 U.S. 391 (1963) 23
Fischman v. Raytheon Manufacturing Co., 9 F.R.D. 707 (S.D. N.Y. 1949) 20
Green v. United States, 355 U.S. 184 (1957) 23
Holmberg v. Armbrecht, 327 U.S. 392 (1946) 20
J. I. Case Co. v. Borak, 377 U.S. 426 (1964) 19
The Johns Hopkins University v. Hutton, et al., 297 F. Supp. 1165 (D. Md. 1968), 422 F.2d 1124 (4th Cir. 1970) 6
The Johns Hopkins University v. Hutton et al., 326 F. Supp. 250 (D. Md. 1971) 2
The Johns Hopkins University v. Hutton, et al., 343 F. Supp. 245 (D. Md. 1972) 2
The Johns Hopkins University v. Hutton, et al., No. 72-1995 (4th Cir. Dec. 4, 1973) CCH Securities Law Reporter, paragraph 94, 302 (12/28/73) 2, 3
Johnson v. Zerbst, 304 U.S. 458 (1938) 23
Joslyn v. Cadillac Automobile Co., 177 F. 863 (6th Cir. 1910) 22
Marsh v. Whitmore, 88 U.S. 178 (1874) 23
McLean v. Clapp, 141 U.S. 429 (1891) 24
Newberg v. American Dryer Corp., 195 F. Supp. 345 (E.D. Pa. 1961) 20
Ohio Bell Telephone Co. v. P.U.C., 301 U.S. 292 (1937) 23
Pence v. Langdon, 99 U.S. 578 (1878) 12, 23
Premier Industries v. Delaware Valley Financial Corp., 185 F. Supp. 694 (E.D. Pa. 1960) 20

PAGE

Reliance Life Insurance Co. v. Burgess, 112 F.2d 234 (8th Cir. 1940) 22
Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962) 15
Royal Air Properties, Inc. v. Smith, 333 F.2d 568 (9th Cir. 1964) 23
SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) 19
Shonts v. Hirliman, 28 F. Supp. 478 (S.D. Cal. 1939) 20
Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) 19
Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1875) 24
United Forest Products Co. v. Baxter, 452 F.2d 11 (8th Cir. 1971) 23
United States ex rel. Linde v. Brierley, 437 F.2d 324 (3rd Cir. 1970) 23
United States ex rel. Snyder v. Mazurkiewicz, 413 F.2d 500 (3rd Cir. 1969) 23
Wilko v. Swan, 346 U.S. 427 (1953) 19
Wood v. Carpenter, 101 U.S. 135 (1879) 20

Statutes and Regulations

Federal Rules of Civil Procedure:
Rule 8(c) 22
Rule 9 4
Rule 11 4

Securities Act of 1933:
§12(2) (15 U.S.C. §771(2)) 3, 8
§13 (15 U.S.C. §77m) 3, 17
§14 (15 U.S.C. §77n) 19
§17(a) (15 U.S.C. §77q(a)) 2, 5, 8
Securities Exchange Act of 1934:
§10b (15 U.S.C. §78j(b)) 2, 5, 8
§27 (15 U.S.C. §78aa) 19
§29(a) (15 U.S.C. §78cc) 19
28 U.S.C. §1254(1) 3

PAGE

Securities and Exchange Commission — General Rules and Regulations, Securities Exchange Act of 1934:
Rule 10b-3 (17 C.F.R. §240.10b-3) 5, 7
Rule 10b-5 (17 C.F.R. §240.10b-5) 5
Rule 15c1-2 (C.F.R. §240.15c1-2) ..... Addendum I

Md. Ann. Code, Art. 57 §1 (1972 Repl. Vol.) 6

Other Authorities

3 Black, *Rescission and Cancellation*, §615, p. 1481 (2d ed. 1929) 22

3 Loss, *Securities Regulation* 1744 (2d ed. 1961) 21

McCormick, *Evidence*, §318 (1954) 22

2A Moore, *Federal Practice*, 1858-63 (1972) 23

3 Pomeroy, *Equity Jurisprudence*, §917 (5th ed. 1941) 24, 25

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Cross-Petitioner The Johns Hopkins University (Hopkins) respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of

Appeals for the Fourth Circuit entered December 4, 1973, and to correct erroneous holdings therein regarding the availability of the remedy of rescission, and the circumstances under which such remedy may be held to be unilaterally waived and relinquished, in an action brought by cross-petitioner Hopkins against respondents W. E. Hutton & Co. (Hutton), within the period of limitations, to rescind Hopkins' purchase of a security from Hutton for the fraud of Hutton in violation of Section 10(b) of the Securities Exchange Act (15 U.S.C. §78j(b)), and Section 17(a) of the Securities Act (15 U.S.C. §77q(a)).

OPINIONS BELOW

The opinion of the Court of Appeals sought to be reviewed is not yet officially reported. It is printed in the Appendix to the Petition of Hutton in No. 73-1166, beginning at page A-1.[1] It affirmed the summary judgment of the District Court for the District of Maryland, 326 F. Supp. 250 (D. Md. 1971) (App. B-1) and 343 F. Supp. 245 (D. Md. 1972) (App. C-1), that Hutton are liable to Hopkins for their fraud in the sale of a security in violation of Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)), but reversed in part for a trial, with the burden of proof placed on Hopkins, of the question whether, solely because of the relatively short time which elapsed before it demanded the remedy of rescission, including the time during which Hopkins was ignorant of its right thereto, Hopkins had lost, by unilateral waiver, that particular remedy.

In an earlier opinion (App. F-1), the District Court had granted Hopkins a summary judgment of rescission of the same purchase for Huttons' same fraud as a violation of

[1] Future references herein to this Appendix will be indicated by "App." and the appropriate page reference.

Section 12(2) of the Securities Act of 1933 (15 U.S.C. §77l(2), 297 F. Supp. 1165 (D. Md. 1968). The Court of Appeals, in 422 F.2d 1124 (4th Cir. 1970) (App. E-1), had affirmed that summary judgment as to Huttons' violation of that statute, *and as to the sufficiency of Hopkins' tender and the propriety and equity of giving Hopkins the remedy of rescission*, but reversed for a trial of the question of Hopkins' compliance with the one-year statute of limitations contained in Section 13 of the Securities Act (15 U.S.C. §77m), compliance with which constitutes a part of the substantive cause of action created by Section 12(2) of the Securities Act, and which has peculiar application to that cause of action, but no application to claims under Section 10(b) of the Securities Exchange Act. These five opinions appear in the Appendix to Huttons' pending Petition for Certiorari in No. 73-1166 as above indicated.

JURISDICTION

The judgment of the Court of Appeals was made and entered on December 4, 1973. Hutton, in No. 73-1166 of this Term, filed a petition for certiorari to review it on January 30, 1974. This cross-petition for certiorari was filed within ninety (90) days of the date the judgment of the Court of Appeals was entered. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

Hopkins' purchase of a security, induced and caused by fraudulent misrepresentations and omissions of Hutton in violation of Section 10(b) of the Securities Exchange Act, took place on March 1, 1961. Hopkins tendered back the security and rescinded the purchase on August 6, 1963, and instituted this action to recover the purchase price on November 1, 1963, well within the Maryland three-year

statute of limitations, the only such statute which could be applicable. Hopkins did not have any actual knowledge or direct information of Huttons' frauds (and no imputed or constructive knowledge thereof by shutting its eyes to any obvious facts) until shortly before it made demand on August 6, 1963 for rescission of the purchase. Hopkins did not take that short time for any speculative or other inequitable reasons, but only to verify and make sure of its grounds. (See Rules 9 and 11 of the Federal Rules of Civil Procedure.) Hutton were not prejudiced by any lateness in Hopkins' demand by any changes in the security since its purchase, or by any changes of Huttons' position, or otherwise.

The above circumstances have been judicially determined by the Courts below. No inequitable motive or advantage to Hopkins and no prejudice to Hutton were found. Therefore, no laches or estoppel by Hopkins existed.[2]

The overall Question Presented, therefore, is:

1. Whether, notwithstanding the above circumstances, Hopkins' right to rescind the purchase can be held to have been lost, by unilateral waiver and relinquishment through mere lapse of time, unless Hopkins bears the burden of proof and convinces a jury that it demanded rescission within a reasonable time, not merely from its actual knowledge or equivalent imputed knowledge, but from the time when, objectively considered, it might have obtained knowledge of Huttons' fraud by making a diligent, affirmative investigation.

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[2] The Court of Appeals mentioned no such defenses or any inequitable features resulting from the mere lapse of time. On the contrary, it held on the first appeal, and affirmed on the second, that "rescission is a proper remedy" for Hopkins' claim under Section 12(2) of the Securities Act 422 F.2d 1124, 1131 (App. E. 13). This could not be true if inequities in addition to mere lapse of time existed. Also it clearly held that Hopkins was entitled to and had not forfeited the relief of money damages.

The above overall question presents these subordinate questions:

2. Whether waiver by lapse of time is the intentional relinquishment of a known right, and must be determined subjectively, and, therefore, whether that part of the time which Hopkins took in demanding rescission of the fraudulent purchase which can be considered in determining waiver, must, as a matter of law, be calculated only from the time Hopkins knew, actually or by imputation, of the existence of the right to rescind and not, as the Court of Appeals held, objectively from the time it might have known of it as the result of affirmative diligence.

3. Whether waiver of the right of rescission (like laches, estoppel, the ordinary conventional statute of limitations, which is not an ingredient of the substantive cause of action, and other matters of avoidance) is a matter of affirmative defense and, therefore, whether the burden of proof with regard to it rests upon Hutton, the party who pleaded that defense, and not, as the Court of Appeals held, upon Hopkins, the party alleged to have unilaterally waived and relinquished the right.

STATUTORY PROVISIONS INVOLVED

The statutory provisions involved are Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b) and Section 17(a) of the Securities Act of 1933 (15 U.S.C. §77q(a)).

The regulations directly involved are Rules 10b-3 and 10b-5 of the General Rules and Regulations, Securities Exchange Act of 1934 (17 C.F.R. §240.10b-3 and 10b-5).

Other statutes involved are:

Section 12(2) of the Securities Act of 1933 (15 U.S.C. §77l(2)), for violation of which by Hutton the District Court,

in an earlier decision, awarded Hopkins a summary judgment of rescission (297 F. Supp. 1165 (D. Md. 1968)) (App. F-1) and which the Court of Appeals, in an earlier decision, affirmed except on the question of the one-year statute of limitations (422 F.2d 1124 (4th Cir. 1970)) (App. E-1).

Section 13 of the Securities Act of 1933 (15 U.S.C. §77m), the one-year statute which has peculiar application to claims under Section 12(2) of the Securities Act because regarded as a part of the substantive rights and causes of action created by Section 12(2), but which has no application to claims for violation of Section 10(b) of the Securities Exchange Act.

All of the above statutory provisions except Rule 10b-3 are printed in Addendum II to the Petition of Hutton in No. 73-1166.

The statute of limitations applicable to claims under Section 10(b) of the Securities Exchange Act and Section 17(a) of the Securities Act of 1933, which was fully complied with by Hopkins in the case at bar, is the three-year statute contained in Maryland Code, 1972 Replacement Volume, Article 57, Section 1, which reads as follows:

> "§ 1. Actions other than those upon specialties.
>
> All actions of account, actions of assumpsit, or on the case, except as hereinafter provided, actions of debt on simple contract, detinue or replevin, all actions for trespass for injuries to real or personal property, all actions for illegal arrest, false imprisonment, or violation of the twenty-third, twenty-sixth, thirty-first and thirty-second articles of the Declaration of Rights, or any of them, or of the existing, or any future provisions of the Code touching the writ of habeas corpus or proceedings thereunder, and all actions, whether of debt, ejectment or of any other description whatsoever, brought to recover rent in arrear, reserved under any form of lease, whether for ninety-nine years renewable forever, or for a greater

or lesser period, and all distraints issued to recover such rent shall be commenced, sued or issued within three years from the time the cause of action accrued; and all actions on the case for libel and slander and all actions of assault, battery and wounding, or any of them, within one year from the time the cause of action accrued."

Rule 10b-3 (17 C.F.R. §240.10b-3) reads as follows:

"It shall be unlawful for any broker or dealer, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security otherwise than on a national securities exchange, any act, practice, or course of business defined by the Commission to be included within the term 'manipulative, deceptive or other fraudulent device or contrivance,' as such term is used in Section 15(c) of the Act."[3]

STATEMENT OF THE CASE

On March 1, 1961, Hopkins, as the result of long, urgent solicitations by Hutton, New York securities brokers (for many years well and favorably known to Hopkins and the members of its Finance Committee), purchased outright for its Endowment Fund from Trice Production Company (Trice), a prospector and developer of oil and gas properties, an oil and gas production payment. Trice's function thereafter was merely to operate the properties, which made the production payment an investment contract and, therefore, a "security". Hutton were paid a substantial commission for making the sale as brokers.

In December 1962, Hopkins for the first time suspected that it had been defrauded in making its purchase and began an investigation which led it to conclude shortly before July 26, 1963, that Hutton had defrauded it. On August 6, 1963, Hopkins tendered Hutton the production payment and de-

[3] Rule 15c1-2 is reproduced in the Addendum to the Cross-Petition.

manded rescission of the transaction, and on November 1, 1963, well within a three-year period of limitations from the date of purchase, filed its Complaint to rescind and recover its purchase money. Hopkins alleged, in Count I, that Huttons' material misrepresentations and omissions concerning estimates by independent engineers of the oil and gas reserves in the wells covered by the production payment violated Section 12(2) of the Securities Act of 1933 (15 U.S.C. §77l(2)); in Counts II and III, that they violated Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)) and the Rules promulgated thereunder; and, in Count V, that they violated Section 17(a) of the Securities Act (15 U.S.C. §77q(a)). The Complaint contained other counts not now important.

After extensive discovery, Hopkins moved for summary judgment on all the above statutory counts. The District Court concerned itself in its first decision with Count I only, and granted Hopkins summary judgment of rescission under Section 12(2) of the 1933 Act. In reaching this conclusion the District Court found that Hopkins had "made a timely tender within the provisions of Section 12(2)" (App. F-117) and that "the equities of this case call for the application of the remedy of rescission" (App. F-122). With respect to the limitations requirements of Section 13 of the 1933 Act (15 U.S.C. §77m) the District Court found that "prior to that date [November 1, 1962] the undisputed facts reveal that plaintiff was not 'possessed of sufficient information to reveal' an even partial glimpse of the false and misleading nature of LaPiere's [Huttons' salesman's] communications, let alone the 'entire picture' of his misrepresentations" and, concluding that the question of whether due diligence was exercised involved simply the application of a standard and therefore a question of law, held that the action had been timely filed (App. F-114 to F-117).

The Court of Appeals concluded (App. E-13), "for reasons adequately stated by the district court, that rescission is a proper remedy . . ." and affirmed on all issues except the issue of compliance with the diligence requirement of Section 13 (15 U.S.C. §77m), holding that Hopkins' diligence should be tested by an *objective* standard and that there was a possible inference that, although Hopkins did not suspect, a reasonable man might have been alerted by certain events occurring after the purchase in 1962 to the possibility of fraud, and might then have begun an investigation which would ultimately have disclosed the fraud. This issue, the Court held, must therefore be remanded for trial. The Court of Appeals did not question the District Court's factual findings with respect to the lack of Hopkins' knowledge on November 1, 1962 and affirmatively held that, when Hopkins had, in the year 1962, received disturbing news with respect to Trice's financial condition and information of delays or reductions in production from certain wells, "Hopkins and its advisers did not stand idly by" but "conducted investigations which led them to believe that Trice's troubles, and Hopkins' own worries, were caused by factors other than deficiencies in the estimates of the future net revenue" (App. E-11), i.e. the estimates which Hutton, by its employee LaPiere, was guilty of misrepresenting.

On remand, Hopkins pressed its motion for summary judgment on Counts II, III and V brought under Sections 10(b) and 17(a), to which Section 13 of the Securities Act had no application and where the only applicable statute of limitations was the three-year Maryland statute. The District Court, after further discovery (particularly with respect to Hopkins' diligence in the period after November 1, 1962), and more briefings and hearings, found the additional elements of Huttons' *scienter* (B-8 to B-11) and Hopkins' reliance (B-11 to B-19) to be also shown by undisputed facts, and

entered summary judgment of Huttons' liability and granted Hopkins rescission under Section 10(b) of the 1934 Act and Section 17(a) of the 1933 Act. There is no question that the action under these sections was filed well within the Maryland three-year Statute of Limitations, the only statute of limitations which could be applicable to the causes of action created by these sections.

The District Court, relying upon *Pence v. Langdon*, 99 U.S. 578, and many other authorities defining and determining the legal elements of the affirmative defense of unilateral waiver (which Hutton pleaded as required by Rule 8(c) of the Federal Rules of Civil Procedure), concluded that Hopkins' demand for rescission under Section 10(b) should be "appraised under criteria substantially different from those imposed by Section 12(2) and the related Section 13 . . .," and granted the relief because Hutton had not sustained their burden of showing unreasonable delay on the part of Hopkins, subjectively considered, in making the demand for rescission after it had actual or imputed knowledge of the fraud. In so holding, the District Court made its view clear that imputed or constructive knowledge would be for this purpose the equivalent of actual knowledge. But it found on the undisputed evidence that Hopkins had not closed its eyes to any obvious facts. Applying this rule, the Court found it to be undisputed that the first information which Hopkins received subjectively indicating to it a possible deficiency in the reserves, but without any suggestion of fraud, was a preliminary statement of opinion, in November, 1962, from Bednar, a petroleum engineer. The District Court then recounted, step by step, Hopkins' investigation begun on December 14, 1962, which was thereafter diligently pursued and completed about July 26, 1963, on which date Hopkins made an appointment for a meeting with Hutton on August 6, 1963, at which it tendered back the security and demanded

rescission. Hutton, who were already carrying on an investigation of its employee, LaPiere, begun in February, 1963, and an investigation in anticipation of Hopkins' claim begun May 9, 1963, requested more time to investigate it, giving "complexity of the matter" as their reason; and they did not deny Hopkins' claim until October 10, 1963 (App. C-15 to C-20). Suit was filed on November 1, 1963.

On a second appeal by Hutton, which was heard by a panel of the Court of Appeals completely different from that which heard the first appeal and in which Hutton did not contest the District Court's finding of *scienter*, the District Court was affirmed as to Huttons' liability under Sections 10(b) and 17(a), and Hopkins' right to relief was recognized. Moreover, the Court of Appeals indicated no disagreement with the factual conclusions of the District Court.

Nevertheless, it reversed and remanded for a jury trial the question of Hopkins' right to obtain the particular relief of rescission. In so doing, the Court of Appeals held that the District Court had erred in concluding that the right to rescind should be determined on the basis of Hopkins' promptness in demanding it after it acquired knowledge, actual or imputed, of the fraud. Rather the Court of Appeals ruled generally that the rule of equity and the burden of proof here *are identical* with those enacted by Section 13 of the 1933 Act, and that all persons who desire to rescind fraudulently induced securities transactions, including Hopkins, have, regardless of other circumstances and of the particular statute conferring the right of action, the burden of persuading a jury that they exercised due diligence, objectively determined, to discover the fraud and that they demanded rescission promptly after the fraud *should have been* discovered in the exercise of such diligence, again applying an objective test (App. A-6 to A-7 footnote 12). It is

that determination which this Court is hereby asked to review.

REASONS FOR GRANTING THE WRIT

1. THE COURT OF APPEALS' DECISION REGARDING WAIVER OF THE RIGHT OF RESCISSION FOR FRAUD DIRECTLY CONFLICTS WITH THE APPLICABLE AND CONTROLLING DECISIONS OF THIS COURT, PARTICULARLY *PENCE v. LANGDON*, 99 U.S. 578 (1878).

Pence v. Langdon, 99 U.S. 578 (1878), this Court's clearest expression on the subject at hand, is a relatively old decision, but no later decision (until the one for which we seek review) has attempted to impair its authority in the slightest degree. On the contrary, it has been cited and used in recent years by many lower Courts in opinions written by judges of recognized great ability.

In *Pence*, plaintiff, in early 1875, purchased from defendant by correspondence stock in a mining company. Defendant told plaintiff, and plaintiff believed, he was buying the stock from the company. Plaintiff claimed that on June 20, 1875, when he visited the mine, he learned for the first time that he had been sold some of defendant's own stock at a price much greater than it was worth. The next day plaintiff rescinded for fraud and demanded return of his purchase price. He later brought an action at law for money had and received to recover the purchase price. The affirmative defenses interposed by the defendant included alleged waiver and acquiescence by reason of plaintiff's supposed delay in rescinding. This Court affirmed judgment for plaintiff on the jury's verdict.

The trial court instructed the jury as follows:

> "Before the plaintiff was required to affirm or rescind the contract, he must be shown to have had actual knowledge of the imposition practised upon him. It is not

enough to show that he might have known or suspected it from data within his reach."

The Supreme Court approved this instruction, saying:

"This, under the circumstances, we think, was exactly right."

The Trial Court also gave this instruction:

"If the jury believe that the plaintiff had no actual knowledge or belief that defendant had put his own stock upon them, until June, 1875, at the mine, then his repudiation of the transaction, if made then, was sufficient."

The Supreme Court approved this instruction also, saying:

"There can be no doubt as to the soundness of this proposition."

This Court also said:

"Acquiescence and waiver are always questions of fact. *There can be neither without knowledge.* The terms import this foundation for such action. One cannot waive or acquiesce in a wrong while ignorant that it has been committed. *Current suspicion and rumor are not enough. There must be knowledge of facts which will enable the party to take effectual action.* Nothing short of this will do. But he may *not wilfully shut his eyes to what he might readily and ought to have known. When fully advised,* he must decide and act with reasonable despatch. He cannot rest until the rights of third persons are involved and the situation of the wrongdoer is materially changed. Under such circumstances he loses the right to rescind and must seek compensation in damages. *But the wrong-doer cannot make extreme vigilance and promptitude conditions of rescission.* It does not lie in his mouth to complain of delay unaccompanied by acts of ownership, and by which he has not been affected. The election to rescind or not to rescind, once made, is final and conclusive.

> *"The burden of proving knowledge of the fraud and the time of its discovery rests upon the defendant."* (Emphasis supplied.)

It is manifest, that, except that in *Pence* suspicion and knowledge were simultaneous, whereas in the case of Hopkins the factual complexities caused several months to elapse between its first suspicion and completion of its investigation, the case at bar is on "all fours" with *Pence*. In neither case was there any laches, or estoppel, or delay for speculation, or other inequity accompanying the rescission. In both, passage of time alone was claimed to constitute waiver. But the ruling in *Pence* eliminates from the passage of time to be considered as waiver, the time during which the plaintiff lacked actual knowledge. And the ruling in *Pence* also places squarely on defendant the burden of proving the alleged affirmative defense of waiver.

In the case at bar, the District Court relied heavily upon *Pence*. But the Court of Appeals merely said of it: "We fail to find *Pence*, which involved the review of a trial court's instruction in an action at law, persuasive on the issue before us . . .". It will be noted that the Court of Appeals' only reason for concluding that *Pence* should be ignored was because its ruling was made in "*an action at law*" for rescission instead of in a proceeding in equity for the same relief. One would suppose that there is just as much reason to apply equitable principles of fairness where the rescission is sought in equity as where it is sought in an action at law for money had and received. Moreover, the Court of Appeals has remanded the case at bar for a trial of this issue which it held will require *instructions* to a jury upon waiver.

2. THE COURT OF APPEALS' DECISION REGARDING WAIVER OF THE RIGHT OF RESCISSION FOR FRAUD VIOLATIVE OF SECTION 10(b) OF THE SECURITIES EXCHANGE ACT DIRECTLY CONFLICTS WITH DECISIONS OF OTHER COURTS OF APPEALS, PARTICULARLY *ROYAL AIR PROPERTIES, INC. v. SMITH*, 312 F.2d 210 (9th Cir. 1962); 333 F.2d 568 (9th Cir. 1964).

In the first appeal in *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962), the Ninth Circuit held that, in an action under Section 10(b) of the Securities Exchange Act to rescind a purchase of a security for defendants' fraudulent material concealment violative of that statute, common law laches, estoppel and waiver were available to a defendant as *affirmative defenses*, if defendant could establish them by proof. On the second appeal, reported in 333 F.2d 568 (9th Cir. 1964), the Ninth Circuit affirmed the District Court in finding that defendant had failed to bear the burden of sustaining by proof any of these three asserted defenses. The Court of Appeals affirmed the findings as to laches and estoppel by saying that defendants had not shown that, after plaintiff had full knowledge of the fraud, they "suffered an injury or detriment sufficient to justify application of the defenses of laches or estoppel". However, its further ruling, and the reasons it gave for it, that the defense of unilateral waiver by mere lapse of time had also not been sustained by defendant is more important here.

Smith purchased his stock in an apartments company on May 16, 1957, as the result of misrepresentations of Heathman, a corporate officer, which included failure to inform Smith that one Hargess had been removed as President of the Company and had demanded repayment of a loan he had made to it. He did not institute his action to rescind until several years after his purchase, but within the applicable three-year Statute of Limitations of the State of

Washington. Before his purchase Smith knew that there had been "some difficulty between Hargess and Heathman". Heathman had then even asked Smith "not to talk with Hargess, in order to avoid widening their dispute". After his purchase, Smith became a director of the company and, at a meeting of the directors on August 29, 1957, first learned that the company had had "difficulty" with Hargess and that he had been removed as a director. At a later meeting of the directors on November 12, 1957, Smith learned that Hargess had demanded repayment of his loan and would not accept the company's stock in place of it. But Smith was not told, and did not know until August 1959, when he first questioned Hargess, that Hargess had made that demand for return of his money in April 1957 before Smith had purchased his stock.

The District Court found, and the Ninth Circuit approved, "that there were many factors which should have aroused plaintiff's suspicions . . . and that it would not have been difficult for him to have fully informed himself", and that Smith "was negligent — perhaps grossly so" in failing to make sooner the inquiries which were prompted and suggested by the alerting information he had about Hargess during the years in which he did nothing. But the District Court also concluded, and the Ninth Circuit affirmed, that this negligent lack of diligence could not constitute unilateral waiver of Smith's right to rescind. The Ninth Circuit said (333 F.2d 568, at p. 571):

> "It has been held by this court that waiver is 'the voluntary or intentional relinquishment of a known right. It emphasizes the mental attitude of the actor.' Since waiver is a voluntary act, there must be knowledge of the right in question before the act of relinquishment can occur."
>
> * * * * * *

"*When waiver is predicated upon facts of which one has inquiry, but not actual notice,* it is no longer intentional. *We feel that waiver of rights under the Securities Exchange Act of 1934 should be limited to those cases where it is intended, and that therefore the right in question must be found to be actually known before waiver becomes effective.* This is as it should be because there is a period of limitations applicable to cases brought under § 10(b); *the statutory period should not be cut short by a waiver with the mental element disregarded.*" (Emphasis added.)

3. THE COURT OF APPEALS HAS DECIDED FEDERAL QUESTIONS CONCERNING THE AVAILABILITY AND WAIVER OF THE REMEDY OF RESCISSION FOR FRAUD VIOLATIVE OF SECTION 10(b) OF THE SECURITIES EXCHANGE ACT, IN CONFLICT WITH BASIC PRINCIPLES OF LAW AND THE REMEDIAL PURPOSES OF THE STATUTE EXPRESSLY RECOGNIZED BY THIS COURT, WHICH QUESTIONS ARE OF GREAT AND RECURRING IMPORTANCE IN ITS APPLICATION.

The errors of the Court of Appeals spring from confusing the affirmative equitable defense of waiver by mere lapse of time with the objective requirement of the one-year statute of limitations contained in Section 13 of the Securities Act of 1933 (15 U.S.C. §77m). Waiver (like laches, estoppel and speculative delay) has been worked out by Courts of Equity as a judge-made defense (to be applied subjectively and personally) against the inequitable exercise of a right a defrauded person usually has to rescind the transaction. In direct contrast, Section 13 of the Securities Act is a special one-year statute of limitations, which by its terms has no application to a cause of action under Section 10(b) of the Securities Exchange Act, but objective compliance with which a plaintiff must bear the burden of proving (because, by reason of its wording and the fact that it was simultaneously enacted with the statute creating the cause of action,

it is an ingredient of his substantive cause of action) for any relief whatever for violation of Section 12(2) of the Securities Act.

The Court of Appeals erroneously treated these two utterly different principles of law as being practically identical. Without citation of any authority which supports the proposition, it rejected the District Court's conclusion "that Hopkins' conduct in seeking rescission under Sections 10(b) and 17 should be appraised under criteria substantially different from those imposed by Section 12(2) and the related Section 13 requirement" (the one-year statute of limitations) (App. A-8). And, again without citation of a single case to support it, the Court of Appeals also held that "in the general area of rescission it appears that the requirement of prompt action is an element of the plaintiff's case, and the burden is upon the rescinding party to show that he acted promptly in seeking rescission". Such identification of the two rules would, of course, make Section 13 surplusage when rescission under Section 12(2) is sought. These rulings of the Court of Appeals are in head-on conflict with basic principles of law which have often been announced and applied by this Court and numerous other Courts of Appeals and District Courts. It thereby erred (1) by its determination of the legal elements of the defense of unilateral waiver by lapse of time; (2) by including in the elapsed time which could constitute such waiver, time during which Hopkins asserted no right because admittedly it was then ignorant of the existence of the right claimed to be waived; (3) by holding that waiver should be applied objectively (and not equitably, subjectively and personally) to cut off the equitable right of rescission; and (4) by imposing on Hopkins the burden of proving that it had not so objectively and unknowingly waived its right.

Correction of these errors now by this Court would speedily end this interminable case and bring justice to Hopkins, and the innocent victim of Huttons' fraud, for which at enormous expense it has battled *for over ten years* to obtain redress. It would relieve this charitable educational institution from suffering great additional delay and expense which will be required by a jury trial to determine its right to this particular relief.

But the *all-pervading* reason for granting the writ is because of the confusion and adverse effect these errors of the Court of Appeals are bound to have upon constantly recurring problems in the administration of, and heavy litigation under, the now all-important Federal securities statutes. The Court of Appeals' rulings are of general application and place this burden of proof of objective diligence upon *every* defrauded would-be rescinder *regardless of circumstances.*

This Court has repeatedly stressed the "remedial purposes" of the Federal securities legislation and has called specific attention to the power conferred by Section 27 of the Securities Exchange Act (15 U.S.C. §78aa) to fashion remedies appropriate to carry out these purposes. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186, 195 (1963); *J. I. Case Co. v. Borak*, 377 U.S. 426, 433 (1964); *Supt. of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971); *Affiliated Ute Citizens v. U. S.*, 406 U.S. 128, 151 (1972). The errors of the Court of Appeals, by its novel and severe restrictions on a usual remedy of defrauded purchasers of securities, conflict directly with these remedial purposes. In enacting these securities statutes Congress expressly made null and void stipulations "binding any person acquiring any security to waive compliance with any provision" of them, 15 U.S.C. §77n and §78cc. See *Wilko v. Swan*, 346 U.S. 427 (1953). The erroneous severe restrictions

which the Court of Appeals has placed upon the right of an innocent purchaser of a security to rescind the transaction for fraud clash with the Congressional policy, manifested by these enactments, of a hostility which extends to waivers of such legal rights, even knowingly and voluntarily made for consideration, by purchasers of securities.

The only decisions which the Court of Appeals cited as supposed authority for these novel rulings upon (1) what legally constitutes the affirmative defense of waiver and (2) who has the burden of proof with regard to it, were:

Newberg v. American Dryer Corp., 195 F. Supp. 345 (E.D. Pa. 1961);

Premier Industries v. Delaware Valley Financial Corp., 185 F. Supp. 694 (E.D. Pa. 1960);

Shonts v. Hirliman, 28 F. Supp. 478 (S.D. Cal. 1939);

Fischman v. Raytheon Mfg. Co., 9 FRD 707 (S.D. N.Y. 1949);

Holmberg v. Armbrecht, 327 U.S. 392, 397 (1946);

Bailey v. Glover, 88 U.S. 342, 348 (1874);

Wood v. Carpenter, 101 U.S. 135 (1879);

Azalea Meats, Inc. v. Muscat, 386 F.2d 5, 8 (5th Cir. 1967); and

Baumel v. Rosen, 412 F.2d 571 (4th Cir. 1969).

But in none of these nine cases, except the last, was there any question whatever of unilateral waiver. The first eight involved extensions of statutes of limitations.

The first four of these cases are completely inapposite, because they merely recognize that Section 13 of the Securities Act (15 U.S.C. §77m), expressly providing (tailor-made exclusively for causes of action under Sections 11 and 12(2) of that Act) a special one-year statute of limitations running from the time the fraud should have been discovered by the

exercise of reasonable diligence, is not the ordinary conventional statute of limitations merely cutting off remedies but is an ingredient of the substantive causes of action created by Sections 11 and 12 of the same statute; and that, *for that reason alone*, the burden of proof as to compliance with it is on the plaintiff. See 3 Loss, *Securities Regulations* (2d ed.) p. 1744. But it is fundamental that Section 13 of the Securities Act may not be borrowed as the statute of limitations applicable to causes of action under Section 10(b) of the Exchange Act. The statutes of limitations of the forum States are borrowed instead for such causes of action, and they, including the three-year Maryland statute applicable to Hopkins' claim, are *conventional* statutes of limitations which go only to the remedy and which must be pleaded as affirmative defenses by the defendant under Rule 8(c) of the Rules of Civil Procedure, who must also bear the burden of proof of establishing them.

In *Holmberg*, the Court of Appeals erroneously thought it was bound to apply strictly a New York ten-year statute of limitations to bar a cause of action in equity created by Federal law, which it was alleged the defendant had fraudulently concealed from the plaintiff. The Supreme Court reversed and remanded for a determination of whether, "by reason of some inequity founded on some change in the condition or relations of the property or the parties", the cause of action might be barred by *laches*. In its opinion, the Supreme Court criticised the lower court, not only for holding that the state limitations period was required to be applied, but also for the Court's attempted strict application of such a statute without considering that the accrual of the cause of action might well have been extended by the defendant's concealment of it, notwithstanding plaintiff's diligence to discover it. But, in the case at bar, we have, first, no question of *laches*, because we have no finding of any

inequity caused Hutton by any time which Hopkins took in demanding rescission. And, second, we have no question here of extending the statute of limitations by postponing accrual of the cause of action because of its fraudulent concealment. The Maryland statute of limitations gave Hopkins three years from March 1, 1961 to bring its action. Hopkins brought its action well within that three-year period and needed no extension. Neither the decision in *Holmberg* nor its *dicta* have any relevance here.

Similarly, *Bailey v. Glover*, *Wood v. Carpenter* and *Azalea Meats, Inc. v. Muscat*, are not in point here. The first two announce and apply the equitable rule which extends, by postponing accrual of the cause of action (but postpones it *only for a diligent plaintiff*), the running of limitations when his cause of action has been concealed from him by fraud. In *Azalea Meats, Inc.*, the Fifth Circuit defined "discovery", for purposes of such extensions provided in a Florida statute of limitations, to include discovery which could have been had by reasonable diligence. Hopkins had no occasion to invoke the doctrine of these cases, because it sued within the statutory period unextended.

Rule 8(c) of the Federal Rules of Civil Procedure expressly requires that waiver (along with laches, estoppel and the conventional statute of limitations) is an affirmative defense which a defendant must plead to avoid waiving it. It follows that the defendant has the burden of proof to establish the defense. See 3 *Black on Rescission and Cancellation* (2d ed.) p. 1481; *McCormick on Evidence* §318; *Reliance Life Insurance Co. v. Burgess*, 112 F.2d 234, 237-38 (8th Cir. 1940); *Joslyn v. Cadillac Automobile Co.*, 177 Fed. 863 (6th Cir. 1910). Presumptions often shift, not the burden of ultimate proof, but the burden of coming forward with evidence; so, in exceptional cases of very long delay, a plaintiff is required to explain it, but only in such cases. Such cases

include *Badger v. Badger*, 69 U.S. 87 (a delay of 31 years) and *Marsh v. Whitmore*, 88 U.S. 178 (a delay of 11 years). Hopkins demanded rescission within 2½ years from the time of Huttons' fraud.

Instead of placing reliance upon the eight inapposite decisions described above, the Court of Appeals should have accorded weight to *Pence v. Langdon*, 99 U.S. 578 (1878), *Royal Air Properties, Inc. v. Smith*, 333 F.2d 568 (9th Cir. 1964), and to the host of authorities which, in many different applications, (a) define waiver to be the intentional voluntary relinquishment of a known right, and (b) hold it to be an affirmative defense which must be pleaded and proved by the defendant. Such authorities include; *Johnson v. Zerbst*, 304 U.S. 458, 464 (1938); *Ohio Bell Telephone Co. v. P.U.C.*, 301 U.S. 292, 307 (1937); *Green v. United States*, 355 U.S. 184, 191 (1957); *Fay v. Noia*, 372 U.S. 391, 439-440 (1963); *Barker v. Wingo*, 407 U.S. 514, 525-526 (1972); *U. S. ex rel. Snyder v. Mazurkiewicz*, 413 F.2d 500, 502-03 (3rd Cir. 1969); *U. S. ex rel. Linde v. Brierley*, 437 F.2d 324, 326 (3rd Cir. 1970); *United Forest Products Co. v. Baxter*, 452 F.2d 11 (8th Cir. 1971); and the numerous other decisions of the lower federal courts as to this and other affirmative defenses collected in *2A Moore, Federal Practice*, 1858-63.

The Court of Appeals did, however, cite one decision on the question of waiver, *Baumel v. Rosen*, 412 F.2d 571 (4th Cir. 1969). In *Baumel* a different panel of the Fourth Circuit had applied the defense of unilateral waiver to deny a plaintiff rescission (awarding him damages instead) in a Section 10(b) case, although his suit was brought within the Maryland three-year statute of limitations. But the factual situation in *Baumel* was completely different from that in *Hopkins v. Hutton*. The security which Baumel was defrauded into selling the defendants, Gulf American common stock, was known to be a great speculation and subject to

enormous fluctuations in value. *Baumel* was found to have deliberately waited and postponed his decision to rescind for speculative purposes for 35 months, during all of which time he *suspected*, had "wind of the malodor", and indeed, "believed" he had been defrauded, — having, during the last 18 months of that speculative waiting period, *full and complete knowledge of the fraud.* During the time Baumel delayed in order to speculate, a 500 share unit of his stock, by stock splits, became 69,200 shares, and, adjusting prices to reflect the stock splits, the value of his stock fluctuated up and down between a low of 14½ cents a share and a high of $15.75 a share.

The decisions which the Fourth Circuit cited for its holding in that case, namely, *McLean v. Clapp*, 141 U.S. 429, 432 (1891) (11 years delay with full knowledge); *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587, 592-593 (1875) (4 years delay with full knowledge), were both cases of long conscious delays for speculative purposes. The dictum for which *Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 303 F.2d 527, 532 (10th Cir. 1962) was also cited stressed the same feature.

Baumel's conscious inequitable conduct justified the Fourth Circuit's decision that it constituted the defense of waiver to his claim to rescind. But in no sense can *Baumel* stand as authority for the present holding that Hopkins has the burden of showing that it did not relinquish its right of rescission by mere lapse of time unaccompanied by any speculation or other inequitable feature or result, during which it neither knew nor suspected that it had been defrauded or had such right.

In addition to the nine decisions analyzed above, the Court of Appeals in the case at bar quoted (App. A-9) as authority an excerpt from Section 917 of *Pomeroy's Equity Jurispru-*

dence, Vol. 3 (5th ed. 1941) to the effect that, after a would-be rescinder has actual or imputed knowledge of the fraud, his delay generally will be "regarded as an *acquiescence*", i.e. a waiver of his right to rescind. But it is clear from this quotation itself, reenforced by the remaining text of this section which the Court of Appeals does not quote, that Pomeroy, by the term "imputed" knowledge, means here that the would-be rescinder *deliberately shut his eyes to obvious facts* pointing to fraud and not merely failed to investigate diligently when he had no suspicions. Section 917 continues as follows after the quotation selected by the Court of Appeals:

> "To this rule there is one limitation: it applies only when the fraud is known *or ought to have been known.* No lapse of time, no delay in bringing the suit, however long, will defeat the remedy, provided the injured party was, during all this interval, *ignorant of the fraud.*" (Italics supplied.)

CONCLUSION

It is manifest that the Court of Appeals, in the face of controlling contrary decisions, committed serious error of great contemporary importance in litigation under the securities statutes, in imposing upon victims of fraud who demand rescission and sue to rescind within the applicable period of limitations and shortly after they know that they have been defrauded, the burden of proving that they have not waived their right to rescind by failing to investigate and discover the fraud before they even suspected it and by failing to demand rescission within a reasonable period from the time they might have discovered it.

Respectfully submitted,

JOHN HENRY LEWIN,
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Attorneys for Cross-Petitioner.

February ....., 1974

ADDENDUM I

Statute Involved

Rule 15c1-2 of the Securities and Exchange Commission (17 C.F.R. §240.15c1-2).

"(a) The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in Section 15(c)(1) of the Act, is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

(b) The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in Section 15(c)(1) of the Act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

(c) The scope of this rule shall not be limited by any specific definitions of the term 'manipulative, deceptive, or other fraudulent device or contrivance' contained in other rules adopted pursuant to Section 15(c)(1) of the Act."

CERTIFICATE OF SERVICE

I hereby certify that on FEB 12 '74, 1974, I served upon Petitioners, Cross-Respondents, three copies of the foregoing Cross-Petition for a Writ of Certiorari by depositing said copies in a United States post office, with first class postage prepaid, addressed to Petitioners' and Cross-Respondents' attorneys of record at their post office address:

John A. Wilson, Esquire and
Michael J. DeSantis, Esquire
53 Wall Street
New York, New York 10005.

I further certify that all parties to be served have been served.

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Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1973

No. 73-1249

THE JOHNS HOPKINS UNIVERSITY,
Cross-Petitioner,

against

WILLIAM E. HUTTON, *et al.*,
Cross-Respondents.

ON CROSS-PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

BRIEF FOR CROSS-RESPONDENTS, HUTTON, IN OPPOSITION TO THE CROSS-PETITION OF THE JOHNS HOPKINS UNIVERSITY

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INDEX

	PAGE
THE QUESTIONS ON HOPKINS' CROSS-PETITION AS PRESENTED BY HUTTON	2
STATEMENT OF THE CASE	5
Hopkins learned further facts, wholly ignored by Hopkins, after March 1, 1961 putting it on inquiry notice	5
In January 1962, Hopkins knew that several wells were not producing or were underproducing	6
Hopkins knew early in 1962 that Trice was "in the red"—on the verge of bankruptcy	6
Further delayed payments; bouncing checks; commingled funds	7
In September 1962, Hopkins distrusts the estimates of production; and the Trice debacle ends in bankruptcy	7
During 1960, 1961, and 1962, there were drastic changes in the production payment and great losses of assets therefrom	8
ARGUMENT	10
I. THE AUTHORITIES FULLY SUPPORT THE COURT OF APPEALS' DECISION THAT HOPKINS, TO OBTAIN RESCISSION WAS REQUIRED TO ACT WITH REASONABLE DISPATCH	10
II. THE COURT OF APPEALS' DECISION WITH RE-	

PAGE

Vast losses and drastic changes in the nature of the production payment occurred during Hopkins' delay ---------- 16

III. Nor is the Decision of the Court of Appeals in Conflict With Decisions of Other Courts of Appeals, Including the *Royal Air Properties* Cases ---------- 16

IV. The Decision of the Court of Appeals is Also in Accord With Basic Principles of Law and the Purposes of the Federal Securities Laws 17

Conclusion ---------- 20

TABLE OF AUTHORITIES

	PAGE
CASES:	
Azalea Meats, Inc. v. *Muscat,* 386 F. 2d 5 (5th Cir. 1967)	11
Badger v. *Badger,* 2 Wall. 87 (1864)	11
Bailey v. *Glover,* 88 U.S. 342 (1874)	10
Baumel v. *Rosen,* 412 F. 2d 571 (4th Cir. 1969) *cert. den.* 396 U.S. 1037 (1970)	11, 12, 18
Goldenberg v. *Bache & Co.,* 270 F. 2d 675 (5th Cir. 1959)	11
Halstead v. *Grinnan,* 152 U.S. 412 (1893)	18
Holmberg v. *Armbrecht,* 327 U.S. 392 (1946)	10
McLean v. *Clapp,* 141 U.S. 429 (1891)	12
Pence v. *Langdon,* 99 U.S. 578 (1878)	13, 14, 18
Royal Air Properties, Inc. v. *Smith,* 312 F. 2d 210 (9th Cir. 1962); 333 F. 2d 568 (9th Cir. 1964)	16, 17
Tobacco and Allied Stocks v. *Transamerica Corp.,* 143 F. Supp. 323, (D. Del. 1956) aff'd 244 F. 2d 902 (3rd Cir. 1957)	11
Twin-Lick Oil Co. v. *Marbury,* 91 U.S. 587 (1875)	12, 18
Wood v. *Carpenter,* 101 U.S. 135(1879)	10, 13
OTHER AUTHORITIES:	
27 *Am. Jur. 2d, Equity,* §§ 162, 167 (1966)	12
37 *Am. Jur. 2d, Fraud and Deceit,* §§ 408, 410, 417, 444 (1968)	12
2 Black, *Rescission and Cancellation,* §§ 536, 541-48 2d ed. 1929)	12
Friedman, *Delay As A Bar To Rescission,* 26 Cornell Law Quarterly 426 (April 1941)	11, 12, 17
3 *Pomeroy's Equity Jurisprudence* (5th Ed. 1941) §§ 817, 917	11, 13

PAGE

STATUTES:

Securities Act of 1933

§ 12(2) [15 U.S.C. § 77 1 (2)] 3, 4, 8, 13, 14

§ 13 [15 U.S.C. § 77 m] 12

§ 17(a) [15 U.S.C. § 77 q(a)] 1, 2, 3, 4

Securities Exchange Act of 1934

§ 10(b) [15 U.S.C. § 78 j(b)] 1, 2, 3, 4, 13, 16, 17, 18

In The

Supreme Court of the United States

October Term, 1973

No. 73-1249

The Johns Hopkins University,
Cross-Petitioner,

against

William E. Hutton, et al.,
Cross-Respondents.

On Cross-Petition For Writ of Certiorari to the United States Court of Appeals For the Fourth Circuit

BRIEF FOR CROSS-RESPONDENTS, HUTTON, IN OPPOSITION TO THE CROSS-PETITION OF THE JOHNS HOPKINS UNIVERSITY

On January 30, 1974, the Cross-Respondents herein ("Hutton") filed a Petition (No. 73-1166) for a writ of certiorari to review the judgment and opinion of the Fourth Circuit, entered December 4, 1973 under § 10(b) of the Securities Exchange Act of 1934 and § 17(a) of the Securities Act of 1933. Hutton's Petition concerned certain elements required, under the circumstances of this case, to found *liability,* viz: reliance and the reasonableness of Hopkins' reliance, and Hopkins' diligence in discovering the alleged misstatements of Hutton. Thereafter, on February 12, 1974, the Cross-Petitioners ("Hopkins") filed a Petition to review the same judgment and opinion, but its Petition concerns only the *remedy* of rescission.

The Questions on Hopkins' Cross-Petition as Presented By Hutton

In Hutton's Petition we have set forth at length the proceedings below and the pertinent facts. These facts are necessary also to an adequate understanding of Hutton's opposition to Hopkins' Cross-Petition. To avoid needless repetition we respectfully refer the Court to that detailed statement of facts. In this brief Hutton will set forth the QUESTIONS PRESENTED on Hopkins' Cross-Petition as Hutton believes they should be stated. But first we point out that Hopkins' statement of its QUESTIONS is premised upon certain unfounded assumptions and arguments. For:

1. Hopkins asserts throughout that it has been held barred from rescission on the ground of "unilateral waiver" (pp. 4, 12-25). Thus, it injects a phantom issue. In fact, Hutton pleaded as defenses to Hopkins' rescission claim under §§ 10(b) and 17(a): that Hopkins was barred by its failure "to act with reasonable diligence" after receiving notice of the alleged misstatements; that Hopkins was barred by "laches" because it "delayed unreasonably in asserting rescission" after Hopkins "knew or should have known" of the alleged misstatements; and that Hutton was "*prejudiced by this delay.*"*

Moreover, the Court of Appeals never mentioned or discussed "waiver," whether "intentional," "unilateral," or otherwise. Instead, the Court expressly held that Hopkins is not entitled to summary judgment of rescission under the traditional federal equity doctrine which requires a plaintiff to act with reasonable dispatch after knowledge or notice of material facts.

---

* On January 7, 1972 the District Court granted Hopkins' motion to amend its Amended Complaint, to assert for the first time under Counts II, III & V a claim for rescission under §§ 10(b) and 17(a). On January 10, 1972 the District Court allowed Hutton to plead the above defenses by amendment to its Answer.

2. Hopkins further asserts that "Hutton were not prejudiced by any lateness in Hopkins' demand by any changes in the security since its purchase" (p. 4). But the evidence is uncontradicted that drastic changes in the nature of its production payment and vast losses of assets occurred during the years of Hopkins' inaction and delay.

Up to the present, more than ten years has elapsed since the purchase of the production payment on March 1, 1961. Hopkins in its Complaint filed November 1, 1963, sought rescission and return of the purchase price only under Count I, § (12(2); and *damages only* under Counts II, III and V, §§ 10(b) and 17(a). Not until after the Court of Appeals had held on February 18, 1970, on the first appeal, that Hopkins was *not* entitled to summary judgment under § 12(2), did Hopkins inform the District Court that it had decided—some seven years after commencing the action—to seek rescission under Counts II, III, and V, §§ 10(b) and 17(a).

3. Hopkins also asserts that it had no "actual", or "imputed", or "constructive knowledge" of Hutton's "frauds" (p. 4). But, the Court of Appeals on the first appeal involving Count I and § 12(2), had found that Hopkins, more than one year before it brought suit on November 1, 1963, had actual knowledge of some of the misstatements charged by it and could readily have discovered all of the alleged misstatements about which it now complains. (422 F. 2d 1124, 1129, 1131; App. E-8, 11, 12).

4. Hopkins further accuses Hutton of "fraud" (p. 4). In fact, the District Court twice refused to rule that Hutton's employee who made the alleged misstatements, "was guilty of fraud in the common law sense" or that he "acted as an evil man." 297 F. Supp. at 1219, 1220 (App. F-104, 105, 107) and 326 F. Supp. at 255 (App. B-8). And the Court of Appeals found also that "the Hutton partners were personally blameless." 422 F. 2d at 1130 (App. E-9).

Hutton will now state the Questions on Hopkins' Cross-Petition as it believes they should properly be presented:

1. Did not the Court of Appeals properly hold that Hopkins is not entitled to summary judgment of rescission under §§ 10(b) and 17(a), because Hopkins had delayed unreasonably in asserting rescission for several years: after it had gained such knowledge, information and notice as would have led a reasonable investor to discover any misstatements; after it had in fact *actually* learned of certain important facts allegedly misstated; and after it had also been given ready access to *all* the pertinent facts.

2. Does not the Court of Appeals' ruling on the first appeal that Hopkins is not entitled to summary judgment of rescission under Count I, § 12(2) also preclude Hopkins from obtaining summary judgment of rescission under §§ 10(b) and 17(a), since the Court of Appeals *then held* that Hopkins had actual knowledge of certain misstatements and could readily have discovered every alleged misstatement prior to November 1, 1962, that is, more than one year before the commencement of the action on November 1, 1963.

3. Did not Hopkins lose its right to rescind because it failed for a period of years to use due diligence in asserting its rights under §§ 10(b) and 17(a), and because during its inexcusable delay, drastic changes and vast loss and waste of assets had occurred, resulting in a production payment greatly depleted in value.

4. Does not Hopkins have the burden of proof under the traditional equity doctrine to show that it sought rescission with reasonable dispatch after knowledge or notice of material facts. But notwithstanding burden of proof, does not the evidence establish overwhelmingly and without contradiction, that Hopkins lost the power to rescind because it delayed unreasonably after having received abundant knowledge and notice of material facts.

5. Did not the Court of Appeals properly reverse the grant of summary judgment of rescission to Hopkins, be-

cause at the very least there are genuine issues of material fact for trial by jury concerning: whether Hopkins lost the right to rescind by failing to assert rescission with reasonable promptness after having "inquiry-notice", that is to say after learning material facts which charged it with such knowledge and notice of alleged wrongdoing as reasonable inquiry would have revealed.*

Statement Of The Case

Hopkins bought the production payment on March 1, 1961 not as "the result of long, urgent solicitations by Hutton," as Hopkins asserts (p. 7) but rather upon the recommendation of Hopkins' legal and investment advisers after seven months of face-to-face negotiations between Hopkins and Trice, the seller. Naess, the senior partner of Naess & Thomas, investment counsel to Hopkins for over 20 years, "introduced" Trice to Baker, the Treasurer of Hopkins. Trice had offered to pay Naess, his friend since 1957, a "2% finder's fee" for monies invested by clients of Naess in Trice production payments. Naess was deeply involved in the purchase and strongly recommended it to Hopkins.

Hopkins learned further facts, wholly ignored by Hopkins, after March 1, 1961 putting it on inquiry notice

For the months of March and April 1961, Trice's payments to Hopkins were $4,041.95 less than the 6% interest which Trice had guaranteed. On August 3, 1961, the $4,041.95 was "still due." Similarly, for the months of May, June, August and December 1961, Trice's payments were less than the 6% interest guaranteed by Trice. In April 1961, the Dollar well was plugged and abandoned, and throughout 1961, Trice failed to remit to Hopkins any proceeds from Pone Gas Unit No. 1. Hopkins never received

* Hereinafter the term "inquiry-notice" will sometimes be used as a convenient shorthand method for referring to: knowledge or notice of facts or information, which would have led a reasonable investor to investigate and which would have led him to discover facts allegedly misstated or omitted or other wrongdoing.

any payments for the month of December 1961 from the Hughes well. Moreover, on December 31, 1961, Hopkins was roughly 70% off target as to the principal specified for payment in the September 16, 1960 Trice brochure.

In January 1962, Hopkins knew that several wells were not producing or were underproducing

In January 1962, Baker, Treasurer of Hopkins, learned: that the reserves for the MacDonald well, i.e. *one-third of all reserves* in the production payment, were not as high as had been estimated by outside consultants; that of the 23 wells, "three or more had not been producing" and an "additional six wells were under or non-producing"; that payments to Bankers Trust, which had a primary position in 18 of the 23 wells in the production payment, were behind schedule; that there had been underproduction on the forecast and that payments to Bankers Trust had been $125,000 under the estimate; and that repayments of principal and interest would be delayed by six months. On January 25, 1962, Baker became "uneasy" about the production payment, and requested that Naess investigate whether Brown, Hopkins' own oil and gas consultant, was reliable in his estimates.

Hopkins knew early in 1962 that Trice was "in the red"—on the verge of bankruptcy

In January and February 1962, Baker, Naess, Canedy, and the Hopkins Finance Committee were fully aware that Trice's current position was "in the red" and that Trice was close to bankruptcy. Hopkins had known since September 1960 that Trice had a serious deficiency in cash and working capital which it needed as owner-operator of the wells.

On February 12, 1962, Hopkins received from Dun & Bradstreet its report containing the Trice balance sheet stating $3,128,761 current assets and $20,936,181 current liabilities, an adverse ratio of nearly 7-to-1. This showed glaring discrepancies in Trice's financial representations.

For, only six days earlier on February 6, Trice had furnished Baker a Trice balance sheet stating $3,153,967 current assets and only $7,669,184 current liabilities. On February 13, 1962, Baker outlined to Naess the Trice balance sheet in the D&B report and the conflicting representation in the Trice balance sheet. But this had no deterrent effect.

Further delayed payments; bouncing checks; commingled funds

In May, June and July, 1962 Baker, Naess, Canedy, Dandridge, a partner in Venable Baetjer, and the Hopkins Finance Committee knew that Trice's payments under the production payment were delayed and behind schedule. In May and June, 1962, Hopkins received two Trice checks aggregating over $24,000 which "bounced" twice. And in June and July, 1962 Baker, Dandridge, and the Committee learned that Trice had *dishonestly commingled* Hopkins' funds and used them for its own purposes. Moreover, at a meeting held on July 3, 1962 with Baker and Dandridge, Berman of Hutton: expressed concern about Trice's financial condition; stated that Trice had commingled funds owing to others than Hopkins; and suggested to Baker and Dandridge that Hopkins "should look into its position with Trice" and do what was necessary to protect its interests.

In July 1962, the Finance Committee confronted Trice with the commingling and the bouncing checks and Hopkins itself took steps to segregate its funds from the funds of Trice. Trice's payments to Hopkins were $7,000 less than guaranteed for July and August of 1962. And in August 1962, Dandridge was again warned that he should watch the Trice situation carefully.

In September 1962, Hopkins distrusts the estimates of production; and the Trice debacle ends in bankruptcy

Up to September 1962, Hopkins had received no revenue at all from the Pone Well and on September 7, Berman reported to Baker that an attorney for Trice participants said there was "enough to put Trice in jail." Later in

September, Hopkins voiced "concern" to its consultant Brown that the wells "were not performing" as anticipated; and Hopkins' Assistant Treasurer asked Brown "how far 'off the target' " Hopkins was "from the amortization schedule" Brown had "originally forecast." Also during this month Baker inquired whether the payments in reduction of principal equalled the estimate Brown had made. On October 15, 1962, *Trice went bankrupt*—more than one year before Hopkins commenced this action on November 1, 1963. The bankruptcy was sufficient in itself to put Hopkins under a duty of immediate and exhaustive inquiry.

Not surprisingly the Fourth Circuit concluded when it ruled that Hopkins is not entitled to a summary judgment of rescission under § 12(2), that (422 F. 2d at 1130; App. E-11):

> "But surely the failure of some wells to produce as scheduled coupled with Trice's lack of candor about its finances might cause a reasonably diligent investor to probe the data upon which he based his purchase. *Had Hopkins compared all the experts' reports, which it had a right to do under the terms of the production payment, it could readily have discovered the untrue statements and the omissions about which it now complains.*"

Hopkins, however, failed to bring suit until November 1, 1963, almost three years after it had first learned of certain basic misstatements, and without ever obtaining the readily available data which would have disclosed every pertinent fact.

During 1960, 1961, and 1962, there were drastic changes in the production payment and great losses of assets therefrom

During the period of delay and inaction by Hopkins—1960, 1961 and 1962 there occurred: (a) loss and waste of assets ranging from $1,600,000 to $2,660,000, caused, in the main, by Hopkins' own acts and omissions which greatly

depleted the value of the production payment; and (b) drastic changes in the well ownership interests, as set forth below:

> (i) Unitization of the wells caused a vast reduction in the underlying reserves owned by Hopkins. The Nunez unitization was the "important reason" for a "drastic $1,166,000 loss of reserves"; and after unitization of Nunez, Hopkins "ended up with less dollars" for the future.
>
> (ii) Faulty operation of certain wells caused heavy losses of reserves: $630,000 from the Hester well; $332,000 from the Woodworth well; $352,000 from the MacDonald well; and $76,000 from the Weatherford well—a total of $1,390,000, or more than Hopkins paid for the production payment.
>
> (iii) Hopkins modified, by agreement, the production payment, resulting in a reduction of reserves securing the payment. And certain wells in the production payment were abandoned entirely;
>
> (iv) Hopkins agreed to the unitization of its interests in several wells, with interests in other wells not in the production payment. So that Hopkins finally had a vastly smaller interest in 110 wells, as against its initial interest in 23 wells.

Thus, the production payment which Hopkins now seeks to hand back to Hutton is a vastly depleted production payment.

The Court of Appeals properly reversed the summary judgment of rescission for Hopkins, stating that (App. A-11):

> "Finding summary judgment inappropriate on this issue of Hopkins' promptitude, we reverse the decree of the district court in that respect and remand for a jury trial upon the issue of whether Hopkins demanded rescission within a reasonable time after it had actual

knowledge of the grounds for rescission or notice of facts which, in the exercise of due diligence would have led to actual knowledge of such grounds."

This standard fairly takes into account the knowledge which Hopkins actually had. And it gives effect to the further knowledge a reasonable investor would have had under the circumstances here presented. Also it is in accord with the traditional equity doctrine which the federal courts have applied for years.

ARGUMENT

I

The authorities fully support the Court of Appeals' decision that Hopkins, to obtain rescission was required to act with reasonable dispatch.

The Court of Appeals applied the traditional equity doctrine that wrongdoing is "discovered" not only when the plaintiff has full knowledge thereof but also when he has knowledge of such facts and information as would lead a reasonable man to inquire and to obtain complete knowledge. It cited *Holmberg* v. *Armbrecht,* 327 U.S. 392, 397 (1946); *Bailey* v. *Glover,* 88 U.S. 342, 348 (1874); and *Wood* v. *Carpenter,* 101 U.S. 135 (1879). Mr. Justice Swayne who, one year earlier, had written the opinion in *Pence* v. *Langdon,* now relied on by Hopkins, discusses, in *Wood* v. *Carpenter* the effect of "notice" on a plaintiff suing for fraud and the burden of proof which that requires (p. 141, 143):

> " 'Whatever is notice enough to excite attention and put the party on his guard and call for inquiry, is notice of everything to which such inquiry might have led. *When a person has sufficient information to lead him to a fact, he shall be deemed conversant of it*' . . . 'The presumption is that if the party affected by any fraudulent transaction or management might with ordinary care and attention, have seasonably detected it, he seasonably had actual knowledge of it' . . .

> *"A party seeking to avoid the bar of the statute on account of fraud must aver and show that he used due diligence to detect it and if he had the means of discovery in his power, he will be held to have known it."*
>
> *"There must be reasonable diligence; and the means of knowledge are the same thing in effect as knowledge itself."* .
>
> "The circumstances of the discovery must be fully stated and proved, and the delay which has occurred must be shown to be consistent with the requisite diligence."*

And, even earlier, this Court in *Badger* v. *Badger,* 2 Wall. 87 (1864), affirming the dismissal of a bill in equity which sought on grounds of fraud to set aside a title obtained by judicial sale, had pointed out the necessity of inquiry by a plaintiff, saying (p. 95);

> ". . . It is true, there is a general allegation, that the 'fraudulent acts were unknown to complainant till within five years past,' while the statement of his case shows clearly that he must have known, *or could have known, if he had chosen to inquire at any time in the last thirty years of his life, every fact alleged in his bill."*

This doctrine requiring that rescission be sought with reasonable promptness after knowledge or notice of material facts, has been recognized also in numerous later decisions. See: *Goldenberg* v. *Bache & Co.,* 270 F. 2d 675, 681 (5th Cir. 1959); *Azalea Meats, Inc.* v. *Muscat,* 386 F. 2d 5, 8 (5th Cir. 1967), *Baumel* v. *Rosen,* 412 F. 2d 571 (4th Cir. 1969) *cert. den.* 396 U.S. 1037); *Tobacco and Allied Stocks* v. *Transamerica Corp.,* 143 F. Supp. 323, 331 (D. Del. 1956) *aff'd* 244 F. 2d 902 (3rd Cir. 1957); 3 *Pomeroy's Equity Jurisprudence* (5th Ed. 1941) § 917; Friedman, *Delay As A Bar To Rescission,* 26 Cornell Law Quarterly,

* Emphasis added throughout.

426, 432 (April 1941) and the cases cited therein; 37 *Am. Jur. 2d, Fraud and Deceit,* §§ 408, 410, 444 (1968) and 27 *Am. Jur. 2d, Equity,* §§ 162, 167 (1966). See also *McLean* v. *Clapp,* 141 U.S. 429, 432 (1891); *Twin-Lick Oil Co.* v. *Marbury* 91 U.S. 587, 592-593 (1875).

As the Court of Appeals in *Baumel* v. *Rosen, supra* (cert. denied), relied on by the Court of Appeals in the present case, said (412 F. 2d at 574):

> "Rescission is a radical move, and the law exacts the election of that course to be asserted without wait. The demand is that advice of the determination be given within a reasonable time after discovery of the ground for rescission.
>
> This principle is stringently administered. *Reasonable time is inceptive from the receipt by the rescinder of word putting him on notice. It is then incumbent upon him to pick up the scent and nose to the source.* ***(citation omitted). If the quest confirms the suspicion, then he must make decision with reasonable dispatch. Failing this, entitlement to rescission disappears."*

Also, as the Court of Appeals properly held, the burden is on the plaintiff, Hopkins, to prove that it sought rescission promptly. See Friedman, *Delay As A Bar To Rescis-*

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* Hopkins' counsel, Venable, Baetjer represented the defendant, Rosen, against whom recission had been asserted in *Baumel.* Venable, Baetjer there argued that § 13 of the 1933 Act, the one year limitations provision, is "consistent with" the "traditional equity doctrine" that "date of discovery" includes the date "on which, in the exercise of reasonable diligence, the plaintiff should have made discovery." (p. 62 of Venable, Baetjer's Brief in *Baumel* v. *Rosen,* 412 F. 2d 571 (4th Cir. 1969)). With those statements Hutton agrees. For Congress having *codified* the already existing common law of rescission in § 12(2), accordingly *codified* in § 13, as well, the already existing common law of inquiry-notice, with a one year limitation provision. The federal courts have also, despite the existence of § 12(2), adapted and implied a private cause of action under § 10(b), which of rational necessity includes not only the common law right to rescind but also the related common law doctrine of inquiry-notice which limits that right—contrary to Hopkins' assertions at p. 18.

sion, Cornell Law Quarterly, Vol. 26 at 428, 452 (1941), cited by the Fourth Circuit in its opinion of December 4, 1973 (n. 12 at App. A-6-7). And see also, 2 Black, *Rescission And Cancellation*, §§ 536, 541-48 (2d ed. 1929); 37 Am. Jur. 2nd *Fraud And Deceit*, § 417 (1968); 3 Pomeroy, *Equity Jurisprudence*, § 817 (5th ed. 1941); the cases cited in these treatises and also by Friedman; and *Wood* v. *Carpenter*, 101 U.S. 135, 140, 141 (1879).

As the Fourth Circuit said in its opinion of December 4, 1973 (n. 12 at App. A-7), "The basis for placing this burden upon the rescinder . . . stems from the drastic nature of the relief sought by the plaintiff . . ."* But, in the circumstances of this case it is not necessary to consider any technical questions of the shifting burdens of proof, such as Hopkins would now raise (pp. 22-23). For, Hutton has adduced overwhelming evidence which establishes beyond doubt that Hopkins delayed for many years, to Hutton's vast prejudice, although Hopkins had knowledge and notice of abundant material facts putting it on inquiry.

Summary judgment in favor of Hutton on the issue of rescission would, we submit, be warranted but at the very least a question for trial by jury is presented under both § 12(2) and § 10(b).

II

The Court of Appeals' decision with respect to Hopkins' right to rescind does not conflict with this court's decision in *Pence* v. *Langdon* or with any other decision of this court.

Pence v. *Langdon*, 99 U.S. 578 (1878) discussed by Hopkins at pp. 12-14 is an action at law in which this Court reviewed a trial court's instructions to a jury which had

* Also, Hopkins' counsel Venable, Baetjer, at p. 68 of their Brief in *Baumel* reviewed the authorities and stated that ". . . the burden is on he who seeks to rescind [Hopkins in the present case] to prove that he acted promptly; that "unreasonable delay in electing to rescind bars the right to rescind"; and that ". . . the delay fatal to rescission is often held to be but a few weeks or months . . ." With these statements also, Hutton agrees.

found that plaintiff was entitled to rescission. Plaintiff had demanded rescission *one day* after he learned of certain misstatements of defendant. This Court found that there was "no proof that he [plaintiff] had the slightest knowledge or even *suspicion* of any foul play". These facts are far different from those in the *Hopkins* case. But, the Court expressly pointed out that a person seeking rescission (p. 581):

> ". . . *may not wilfully shut his eyes to what he might readily and ought to have known.* When fully advised he must decide and act with reasonable dispatch. He *cannot rest until the rights of third persons are involved and the situation of the wrong-doer is materially changed.* Under such circumstances he loses the right to rescind, and must seek compensation in damages."

Here, Hopkins had actual knowledge of highly significant misstatements, but, it "shut its eyes" to what it "might readily and ought to have known". So found the Fourth Circuit, on the first appeal, when it held that Hopkins was not entitled to summary judgment of rescission under Count I § 12(2), saying (422 F. 2d 1124, 1129, 1131 (App. E-8, 11):

> "Shortly before the purchase of the production payment [on March 1, 1961], Trice furnished information which disclosed that the estimates for thirteen wells came from sources other than D&M [Degolyer & MacNaughton]. *To this extent, the information revealed [to Hopkins] LaPiere's misstatements about the identity of the estimators.*"
>
> • • •
>
> "*Before November 1, 1962* Hopkins learned that Trice was in financial trouble, that some of its checks were returned for insufficient funds, that Trice's report of its financial condition could not be reconciled with Dun & Bradstreet's, that the return from another production payment [Bankers Trust] was behind schedule, that

some of the wells underlying Hopkins' payment were not producing or were underproducing, and that an involuntary petition for bankrupcty had been filed against Trice."

• • •

". . . But surely the failure of some wells to produce as scheduled coupled with *Trice's lack of candor about its finances might cause a reasonably diligent investor to probe the data upon which he based his purchase.* Had Hopkins compared all the experts' reports, which it had a right to do under the terms of the production payment [prior to purchase], *it could readily have discovered the untrue statements and the omissions, about which it now complains."*

Hopkins' inexcusable disregard of important facts which it did know and inexcusable ignorance of other facts which it could readily have found out is also clearly apparent from the events of the significant meeting of February 7, 1961, almost a month before the purchase, at the offices of Venable, Baetjer.* That meeting was not attended by LaPiere or by any other representative of Hutton. Mitchell of Trice offered to provide to Baker and Dandridge "any information" required. But Baker never asked for or obtained the experts' reports which contained information with respect to the reserves radically different from that in the original September 16, 1960 Trice brochure. Instead, Hopkins and its own legal and financial advisors had obviously decided to "go it alone." They had determined to rely wholly, as they did thereafter: (a) upon a new and drastically different superseding Trice brochure of February 3, 1961, never seen by Hutton and for which it had no responsibility; (b) upon the Trice special financial guarantee of February 23, 1961, also never seen by Hutton as to which the Court of Appeals expressly held: "Hopkins

* For details of this meeting see Hutton's Petition For Certiorari at p. 11.

would not have purchased the production payment without Trice's guarantee"; and (c) upon such inexcusably meager information as Hopkins and its own advisors themselves chose to regard as satisfactory.

Clearly the action of the Fourth Circuit, in reversing summary judgment of rescission in favor of Hopkins is entirely in accord with *Pence* in the light of what Hopkins actually knew and what it might readily have known.

Vast losses and drastic changes in the nature of the production payment occurred during Hopkins' delay

Highly significant also is the fact that during the period of Hopkins' delay and inaction—1960, 1961 and 1962: (a) there were vast losses and waste of assets of some several million dollars which greatly depleted the value of the production payment; and (b) there were, also, drastic changes in the ownership interests purchased by Hopkins. But, despite the vast drop in value of the production payment Hopkins failed to assert its claim for rescission promptly. This made the basic objective of rescission impossible—namely, the return of the parties to *status quo ante*. Instead, in the words of *Pence:* Hopkins "rested" until the rights of third persons became involved and the "situation" of Hutton "materially changed". Thus, under the decision in *Pence* also Hopkins has lost its right to rescind.

III

Nor is the decision of the Court of Appeals in conflict with decisions of other Courts of Appeals, including the *Royal Air Properties* cases.

Royal Air Properties, Inc. v. *Smith,* 312 F. 2d 210 (9th Cir. 1962) (first appeal), cited by Hopkins (p. 15), merely holds at p. 214 that since the right of action created for violation of § 10(b) may be enforced at law or in equity, it is "subject to the doctrine of laches as well as the statute of limitations". But this is not here at issue. *Royal Air*

Properties, Inc. v. *Smith,* 333 F. 2d 568 (9th Cir. 1964) (second appeal) is cited by Hopkins principally for the Court's views concerning "waiver" as a defense (pp. 15-17). But, as already noted (p. 2), the Fourth Circuit does not even mention the term "waiver" in either of its opinions. See the defenses as actually pleaded by Hutton (p. 2 *supra*). The Fourth Circuit on the second appeal expressly applied the common law rule that prompt action after knowledge or notice of material facts, is an element of the rescinder's cause of action. See Friedman, *Delay As A Bar To Rescission,* 26 Cornell Law Quarterly at 428, 452 (1941) (App. A-6, A-7). Obviously misplaced is Hopkins' reliance on *Royal Air Properties.*

Moreover, the facts in *Royal Air Properties* clearly distinguish that case from the *Hopkins* case. There, the plaintiff was a doctor "exceedingly gullible", "divorced" from the business world. (333 F. 2d at 572) He had no knowledge of the alleged misstatements made to him. Hopkins, on the other hand, was an experienced and knowledgable investor advised by an eminent Finance Committee, and by legal and investment counsel. It had actual knowledge of glaring misstatements, several years before it took action. These facts in themselves distinguish the *Hopkins* case.

Significant, also, is the fact that the Court in *Royal Air Properties,* in excusing the plaintiff's lack of diligence, held that the delay had not prejudiced the defendant. But it did point out that a lack of diligence will bar a claim for return of the purchase price under § 10(b) when the delay "... has resulted in a disadvantage" to the party [Hutton] against whom rescission is asserted. 333 F. 2d at 570.*

There would obviously be "disadvantage" and vast prejudice to Hutton, if it should be required at this late date to return to Hopkins the purchase price in exchange for the production payment, now massively depleted in value

* See Hutton's affirmative defenses, set forth *supra,* p. 2.

due to Hopkins' delay and acts of omission and commission. The Fourth Circuit's decision does not conflict in any way with *Royal Air Properties, Inc.* v. *Smith.*

IV

The decision of the Court of Appeals is also in accord with basic principles of law and the remedial purposes of the federal securities laws.

Hopkins at pp. 15-25 argues that "the *all-pervading* reason for granting the writ is because of . . . confusion and adverse effect" arising from the Fourth Circuit's "errors". But the Fourth Circuit's decision is both an appropriate and a consistent application of the equitable principle requiring that equitable rights be asserted with reasonable promptness. It results in no "confusion" and Hopkins has shown none.

The cases cited by the Court of Appeals which Hopkins seeks to distinguish at p. 20, uniformly hold that a plaintiff is time-barred if he delays in *bringing suit* when he knew or ought to have known of alleged wrongdoing. This is wholly consistent with the ruling in *Pence* v. *Langdon* that a plaintiff "loses his right to rescind" where he "shuts his eyes" to the facts which "he might readily and ought to have known." In each case, the principle is the same. And the application is especially appropriate to the right of rescission because of the drastic nature of the remedy.

Hopkins ignores the basic equitable principle of reasonable promptitude, when it asserts with an implication of finality (p. 22) that it brought suit within the three year Maryland statute of limitations. For that principle operates independently of the statute of limitations. See: *Halstead* v. *Grinnan,* 152 U.S. 412, 416-417 (1893); *Twin-Lick Oil Co.* v. *Marbury,* 91 U.S. 587, 591 (1875); *Royal Air Properties, Inc.* v. *Smith,* 312 F. 2d 210, 214 (9th Cir. 1962).

Also, Hopkins attempts at pp. 23-25 to distinguish *Baumel* v. *Rosen*, 412 F. 2d 571 (4th Cir. 1969) *cert. den.* 396 U.S. 1937 (1970). In that case, the Court of Appeals held the plaintiffs barred from rescission under § 10(b), although they had brought suit within the three year Maryland statute of limitations. Hopkins asserts (p. 24) that "Baumel's conscious inequitable conduct justified the Fourth Circuit's decision that it constituted the defense of waiver..." But in fact the Court did *not* hold that plaintiffs were aware of or "conscious" of the wrongdoing and it did not hold them barred by "waiver." What the Court did hold was: that more than three years before bringing action, the plaintiffs had (412 F. 2d at 574), "*wind* of the malodor" —not actual knowledge of the cause of the "malodor"; and that accordingly, under the common law of rescission, it was then "incumbent upon [plaintiffs] to pick up the scent and *nose to the source*"—that is, to the defendant's misstatements of financial condition.

Hopkins also erroneously asserts (p. 24) that the plaintiff Baumel had "full and complete knowledge of the fraud" for a period of 18 months before asserting rescission. But the Court on the contrary only found that plaintiffs were then (412 F. 2d at 574, 576) "... *chargeable with* complete awareness of the knavery" because they then "... knew *or should have known*" of their "dupery."

Hopkins, however, had actual *knowledge* of certain basic misstatements, among other things, and yet "deliberately shut [its] eyes to obvious facts" which clearly pointed to other misstatements and to wrong-doing, and yet it decided to "go it alone" and make the purchase.

Contrary to Hopkins' argument at pp. 19-20, the Fourth Circuit's rulings have not penalized an "innocent purchaser of a security." Nor would its rulings force a "waiver" upon Hopkins. On the contrary, the principle applied by the Fourth Circuit fairly holds that Hopkins with knowledge and sufficient information to take effective action, could not

thereafter delay unreasonably in asserting the drastic remedy of rescission. And, this principle is especially just in its application, where, as here, massive prejudice and loss have resulted to Hutton from Hopkins' delay and inaction.

Conclusion

For the foregoing reasons, Hopkins' Cross-Petition to review the judgment and opinion of the Fourth Circuit, should be denied.

Respectfully submitted,

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March 13, 1974

Certificate of Service

I hereby certify that on March 13, 1974, I served upon Respondent three copies of the foregoing Brief For Cross-Respondents, Hutton, In Opposition To The Cross-Petition Of The Johns Hopkins University by depositing said copies in a United States post office, with first class postage prepaid, addressed to Respondent's attorneys of record at their post office address:

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I further certify that all parties required to be served have been served.

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